

The Carry Trade

Did you know there is a trading system that can make money if price stayed exactly the same for long periods of time?

Well there is and it's one the most popular ways of making money. It's called the "Carry Trade".¹

Definition: A carry trade is a strategy in which an investor borrows money at a low interest rate in order to invest in an asset that is likely to provide a higher return. This strategy is very common in the foreign exchange market.

How does it work?

While you are paying the low interest rate on the financial instrument you borrowed/sold, you are collecting higher interest on the financial instrument you purchased. Thus your profit is the money you collect from the interest rate differential.

Interest rate differential? Sounds familiar? That's because the carry trade is related to the topic of Swap Rates.

If your trade entails a positive swap rate, you have essentially carried out a carry trade. If your swap rate is negative, you are on the wrong side of the carry trade.

Example

Let's say you go to a bank and borrow \$10,000. Their lending fee is 1% of the \$10,000 every year. With that borrowed money, you turn around and purchase a \$10,000 bond that pays 5% a year.

What's your profit? You got it! It's 4% a year! The difference between interest rates! By now you're probably thinking, "That doesn't sound as exciting or profitable as catching swings in the market."

However, when you apply it to the spot forex market, with its higher leverage and daily interest payments, sitting back and watching your account grow daily can get pretty sexy.

To give you an idea, a 3% interest rate differential becomes 60% annual interest a year on an account that is 20 times leveraged!²

¹ <http://www.babypips.com/school/undergraduate/freshman-year/carry-trade/what-is-carry-trade.html>

² <http://www.babypips.com/school/undergraduate/freshman-year/carry-trade/what-is-carry-trade.html>

Should we always aim for positive swap rate?

We should view the carry trade as an independent part of our trading strategy. The value and considerations involving a carry trade strategy is different from that of your robot.

Net effect of your robot

Profits from Robot	Profits from Carry Trade	Net Effect
Positive	Positive	Positive
Positive	Negative	Depends
Negative	Positive	Depends
Negative	Negative	Negative

How to Design and Execute a Carry Trade Strategy

A carry trade is mainly based on macroeconomic factors. That's not the focused on this course, but if you are interest to learn more, check out:

Currency Carry Trade: http://www.babypips.com/school/undergraduate/freshman-year/carry-trade/how_do_carry_trades_work_for_forex.html

Macroeconomic Psychology: <http://www.babypips.com/school/undergraduate/freshman-year/carry-trade/to-carry-or-not-to-carry.html>

Risks and rewards: <http://www.babypips.com/school/undergraduate/freshman-year/carry-trade/carry-trade-criteria-and-risk.html>

Yen Carry: <http://www.forbes.com/sites/investor/2014/09/04/carry-trade-the-multi-trillion-dollar-hidden-market/>